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DE RUEHLO #2486/01 2741426  
ZNR UUUUU ZZH  
R 301426Z SEP 08  
FM AMEMBASSY LONDON  
TO RUEHC/SECSTATE WASHDC 9943  
INFO RUCNMEM/EU MEMBER STATES COLLECTIVE

UNCLAS SECTION 01 OF 02 LONDON 002486

H FOR CODEL SHELBY

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E.O. 12958: N/A

TAGS: [ECON](#) [EFIN](#) [KTFN](#) [UK](#)

SUBJECT: SCENESETTER FOR CODEL SHELBY'S OCTOBER 10-12 VISIT TO  
LONDON

Summary

1. (SBU) The UK economy is reeling from the effects of the global economic crisis, with housing prices falling even faster and further than in the United States. The UK economy continues to slide into recession with negative GDP growth forecast for the second semester of 2008. Inflation, fueled by energy, food, and import prices, is projected to hit 5 percent. Prime Minister Brown has been personally engaged in trying to mitigate the effects on the UK economy and to hammer out global solutions. Brown met with the President September 26 to discuss the global economic crisis and appropriate U.S./UK government responses. On the margins on the UN General Assembly Meeting in New York, Brown also met with various heads of state and leaders of the financial sector to explore options for intervention.

He has publicly called for the creation of an international financial watchdog, whose goals would be to increase transparency, improve cooperation with regulators, create better early-warning systems, and shore up credit-rating agencies duties. UK officials would be greatly interested in hearing the details of the U.S financial support package.

2. (SBU) The bleak economic picture has weakened the embattled Prime Minister, who has seen his poll numbers drop significantly over the past year. The PM did however manage to reassert his leadership during the recent Labour Party Conference. Labour received an immediate bounce from the annual event, with poll ratings jumping to 31 percent from 17, while the Conservatives dropped from 50 to 41 percent. (The Conservative Party holds its Congress this week so Labour's gains might be short-lived.) As Chancellor, Brown imposed strict limits on deficit spending to control public debt, but Labour policies during the past ten years of economic growth now leave little room for fiscal stimulus without abandoning these limits.

3. (SBU) The British government strongly supports U.S. anti-terrorist finance efforts, but has resource constraints and legal limitations which obstruct it from being as proactive as the USG would like. End Summary

The Meeting with the President

4. (SBU) PM Brown was to raise with the President his idea for an international financial watchdog, to be set up through an existing entity such as the G-20. Brown attended the UN General Assembly in New York and gave a speech calling for coordinated international action to resolve the financial crisis. While in New York, Brown discussed this and other ideas for a global response to the financial crisis with world leaders (Spain, Italy, EU, Australia, Brazil) and with Wall Street titans (George Soros, BlackRock, Blackstone.) So far it appears that Brown's proposals have not gained much traction.

Difficult Times for PM Brown

5. (SBU) PM Gordon Brown appears to have successfully reasserted

his leadership of the Labour Party and bought himself some time against possible leadership challengers following the Labour Party Fall Conference in Manchester September 20-24. Reaction to Brown's September 23 speech, billed in advance as the "speech of his life," was well received by delegates in Manchester. Attendees told Embassy London officials they thought the PM hit all the right notes and successfully managed to put the Conservative Party on the defensive going into its conference starting on September 29, especially over Tory lack of recent economic experience. Although Brown has refused to comment publicly on a possible Cabinet reshuffle, media reports he could announce a new Cabinet lineup on October 2 or 3, just after the Tory Party conference ends.

¶6. (SBU) Although PM Gordon Brown has recently gained ground in the polls, he does not have nearly the latitude Tony Blair had to take on a major new foreign policy commitment or personally lead the UK public to support a difficult foreign policy decision such as a new commitment of UK troops abroad. The British public is also very skeptical about new foreign commitments and uncertain about medium-term outcomes in Afghanistan. Although the Iraq War has faded from the domestic political landscape with Blair's resignation, the war has almost no popular support. Afghanistan is still considered the "good war" in comparison to Iraq, and UK military engagement has cross-party support in Parliament. Nonetheless, Afghanistan is also increasingly viewed in the UK media as a complicated, uncertain venture with no clear end, especially as British military deaths have spiked over the past year.

#### The Financial Crisis in the UK

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¶7. (SBU) The global financial crisis has reverberated in the UK,

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with home prices having fallen about 11 percent since their peak, and inflation at a ten-year high. Thousands of employees in the financial services sector have lost their jobs as a result of the crisis. Because the UK financial service industry in recent years has provided around 20% of the UK government's tax revenues, the faltering financial market will significantly reduce the government's tax receipts.

¶8. (SBU) GDP growth in the UK was 0.0 per cent in the second quarter of 2008, the worst quarter in 16 years. Inflation hit 4.7% in August, and the Bank of England predicts it will rise to 5% by the end of the year. Employment numbers remain relatively stable, but unemployment has ticked up to 5.5%. The Bank of England is faced with the tough choice of combating inflation or attempting to spur economic growth.

¶9. (SBU) The PM and his economic team have been criticized for a perceived failure to address the concerns of the average citizen, and many have speculated that the PM is politically vulnerable. The PM's speech to Labour party officials, in which he underscored that he was the right person to be at the helm during a financial crisis, has given him some breathing room to turn poll numbers around. To date, the Labour Government has nationalized two large banks (Northern Rock and Bradford and Bingley), but has not proposed widespread structural support or reform measures to shore up the financial sector, though several smaller measures have been adopted. BOE has supported dollar money markets through a recent \$40 billion overnight facility. The UK government followed the U.S. lead in banning the short-selling of stocks, and has created a liquidity scheme.

¶10. (U) The government gave its consent to Barclay's recently announced agreement to purchase HBOS, the UK's largest mortgage lender. A year ago, such a merger would have been unthinkable on competition grounds, but the risk to the stability of the UK financial system posed by HBOS trumped competition rules. To ensure that a Barclays/HBOS deal could be reached quickly, Secretary for Business, John Hutton, took the extraordinary step of announcing the government's intention to intervene "in the public interest" and override UK competition law. A government intervention will require legislation, which will not be considered until Parliament resumes on October 6.

## UK Reaction to Events in the U.S.

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¶11. (SBU) The Labour government has been closely watching actions in Washington. Senior Treasury officials told us approval of a financial support package in Washington was essential to calming the markets globally. With Barclays and Lloyds having significant market share in the U.S., the eligibility of UK financial institutions to the proposed \$700 billion facility was on PM Brown's agenda with President Bush. On September 20, Brown said that he would seek support from the USG to have \$8 billion returned to Lehman UK from Lehman New York, transferred on the eve of Lehman New York's collapse. The PM has indicated that the money would be used to pay final salaries to UK-based employees.

## Terrorist Finance

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¶12. (SBU) The UK remains our primary and most reliable ally on terrorist finance issues. Our goals and ideals are very similar, and we openly share information and coordinate on individual designations and overall strategy. The UK's domestic asset-freezing regime, however, has been challenged by the High Court (trial court), and HM Treasury has argued to maintain their system in the Court of Appeals. A decision is due soon, and will assist the British government in determining their red-lines in modifying the EU's asset-freezing regime, which has also been partially challenged by a European Court of Justice decision. Due to resource constraints, and concerns about legal challenges from increasingly assertive UK and European courts, the British government is not as proactive as the USG wishes. They have prioritized their cases to those that have a direct effect on British soil, interests and/or UK citizens.

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